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Corporate tax treatment of income (profit) received from foreign branch 2/45/22

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In one of our previous articles we looked at a Latvian-registered branch paying profits to a Lithuanian company and examined the corporate income tax (CIT) implications. This article explores the CIT implications of income (profit) that a Latvian company receives from its foreign branch.

Background

A Latvian company ("LV Co") has registered a branch in Lithuania. The branch is trading at a profit and intends to pay income (profit) to LV Co. The Latvian company intends to distribute its profit in dividends.

This raises questions about the tax implications of receiving the branch's income (profit) and the CIT treatment of LV Co's profit distribution.

CIT treatment

According to the OECD's generally accepted principles, a permanent establishment (PE) is treated as a separate domestic taxpayer. So the branch is considered a Lithuanian taxpayer governed by Lithuanian law.

Since the branch pays CIT, we should examine the Latvian tax implications when LV Co receives income (profit) from the branch and when LV Co distributes its profit in dividends.

Tax implications of receiving income (profit) from the foreign branch

When receiving income (profit) from the branch, LV Co is subject to the general CIT treatment rule, which states that CIT is payable on a profit distribution or a deemed distribution. Accordingly, receiving the branch's profit has no CIT implications for LV Co.

CIT treatment of distributing profits including income (profit) received from the branch

The CIT treatment where a company wishes to distribute profits received from its foreign PE is prescribed by section 15(4) of the CIT Act. The taxpayer is allowed to reduce dividends included in the taxable base for the tax period to the extent he has received the PE's income during the tax period if the PE pays foreign tax on its income or if foreign tax has been withheld on the income received by the Latvian taxpayer. So, if LV Co wishes to distribute its profit in dividends, the profit received from the branch may be deducted from dividends included in the taxable base.

To qualify for this relief, LV Co and the branch must keep their accounting records separately for CIT purposes, and LV Co must hold documentary evidence confirming its right to claim the CIT relief, such as a tax residence certificate, the branch's CIT return showing the CIT charge on the income (profit), or confirmation of the CIT paid.

But what steps should LV Co take if the profit received from the branch is greater than LV Co's own profit available for distribution, or if the foreign tax paid is greater than the CIT charge on dividends? In that case, section 15(6) of the CIT Act should be applied. This means the company may offset the difference in subsequent tax periods chronologically against dividends included in the taxable base and against the CIT charge on dividends, respectively.

The reporting obligation

When reporting dividends on line 1 of the CIT return, LV Co should also complete the table on line 2 to give details of the income received from the branch, i.e. when it was received and who paid it. This will have the effect of reducing dividends included in the taxable base, so receiving the income (profit) from the branch will have no tax implications for LV Co.